No. 77-1724

IN THE

Supreme Court of the United States

October Term, 1977

HARRY G. BURKS, Jr., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

PETITIONERS' REPLY

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In our Petition, we showed (1) that this case presents an important question of federal law that has not been, but should be, decided by this Court; (2) that the decision of the United States Court of Appeals for the Second Circuit is in conflict with prior decisions of this Court and another Court of Appeals; and (3) that the decision of the Court of Appeals has no basis in the Investment Company Act of 1940 and its legislative history.

Respondents'* Brief in Opposition now abandons the opinion of the Court of Appeals and seeks to justify the result below on entirely different grounds. Thus, plaintiffs argue (Brief in Opposition, p. 19):

> "... while the decision may be couched in terms of the Investment Company Act it is basically a cor-

* In this Reply, as in the Petition, respondents are referred to as "plaintiffs" and petitioners as "defendants".

porate law determination founded on the most well settled general principles."

Defendants and the District Court—not plaintiffs—relied on "well settled general principles." These principles were rejected by the Court of Appeals in footnote 14 (567 F.2d at 1212, n.14):

> ". . . the plethora of cases cited by counsel dealing with the powers of boards of directors to terminate stockholder derivative suits and the effect of the demand requirement under Fed.R.Civ.P. 23.1 are inapposite. We base our decision on the unique nature of the investment company and its symbiotic relationship with its investment adviser; we need not reach questions of the exercise of similar power by directors of other types of corporations."

State and federal corporate law decisions—including those involving mutual funds—emphasize the importance of determining whether the directors who make decisions on behalf of a corporation are independent. Thus, the Court of Appeals had to deal with the District Court's findings of fact that each of the directors constituting the quorum to which Fundamental's board delegated the responsibility for deciding whether to pursue plaintiffs' proposed lawsuit was truly disinterested and independent. This the Court of Appeals did by relying on selected portions of the Investment Company Act of 1940 to buttress its ruling that, *as a matter of law*, no director of an investment company in circumstances such as those presented here could ever be considered independent.

As shown in defendants' Petition and the *amicus curiae* briefs submitted by other concerned parties, for this Court to leave such a clearly erroneous construction of the Investment Company Act of 1940 standing would have seriously deleterious effects upon the mutual fund industry. It would also leave standing a legally improper and inequitable result in the instant case, with potentially important precedential effects for other similar actions.

Reply to Plaintiffs' Point I

1. Plaintiffs argue that demand under Rule 23.1. Fed.R.Civ.P. (hereinafter "Rule 23.1") was allegedly excused, and, accordingly, the quorum of independent directors could not decide to terminate the action. Thus, they write (Brief in Opposition. p. 6):

> "Obviously, if the minority cannot prevent commencement, it similarly cannot cause termination."

No case so holds, and several decisions contradict that conclusion. See, e.g., *Wolf* v. *Barkes*, 348 F.2d 994, 997 (2d Cir.), *cert. denied*, 382 U.S. 941 (1965); *Alleghany Corp.* v. *Kirby*, 344 F.2d 571 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966); *Goodwin* v. *Castleton*, 19 Wash.2d 748, 144 P.2d 725 (1944). See also: *Brody* v. *Chemical Bank*, 517 F.2d 932, 934 (2d Cir. 1975), discussed in the first opinion of the District Court below (404 F.Supp. at 1178).

The plain fact is that Rule 23.1 cannot alter the substantive powers of corporate directors. See 28 U.S.C. § 2072 (1978). Here, there was a change in the personnel on the board after plaintiffs instituted their suit, and Rule 23.1 cannot freeze all action and preclude the corporation from acting in its own best interest. A corporation must be able to evaluate whether it should prosecute the claims raised by a derivative suit in light of circumstances occurring after the suit has been brought, e.g., where there is a

settlement of related litigation, as here, or where there is a settlement of the controversy between the corporations and the defendants in the derivative suit, as occurred in *Wolf* v. *Barkes*, 348 F.2d 994 (2d Cir.), *cert. denied*, 382 U.S. 941 (1965) and *Goodwin* v. *Castleton*, 19 Wash.2d 748, 144 P.2d 725 (1944).

Although many of the decisions upon which plaintiffs rely hold that demand on a corporate board is not required as long as a derivative plaintiff demonstrates in his complaint that a numerical majority of the board is disqualified from passing on the matters at issue, none of those cases involved a lawful delegation of authority to an independent quorum of directors, which quorum became the entire board for purposes of exercising business judgment with respect to the proposed claim. Defendants' position, and that of the parties appearing *amicus*, is that it is wrong for a federal court to ignore that delegation and the good faith exercise of business judgment by Fundamental's directors, all of whom were found to be independent of the delegating majority after extensive discovery on that limited issue.*

2. Plaintiffs (and the Court of Appeals) next seek to make much of the fact that the directors who functioned on this matter were a minority of the full board (five of 11 members). This argument ignores the fact that both

* The further argument that Rule 23.1 required notice to the shareholders and a judicial determination that dismissal was fair misconstrues that portion of Rule 23.1. Under Rule 23.1, *voluntary* dismissals require notice to stockholders and court approval after a hearing, but that rule does not govern *involuntary* dismissals as at bar, where there is no risk of collusive settlement. *Wolf* v. *Barkes*, 348 F.2d 994, 995-97 (2d Cir.), *cert. denied*, 382 U.S. 941 (1965); *Marcus* v. *Textile Banking Co.*, 38 F.R.D. 185, 187 (S.D.N.Y. 1965). See also: Simeone, *Procedural Problems of Class Suits*, 60 Mich.L.Rev. 905, 934 (1961-62); Miller, *Problems of Giving Notice in Class Actions*, 58 F.R.D. 313, 331 (1973).

the Fund's certificate of incorporation and Delaware law expressly authorize the board to act through a quorum, which, in this case, was four directors. Neither the Investment Company Act of 1940 nor existing case law prohibits such action by a lawful quorum of the board of directors. Cf. *Sante Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 479 (1977). Indeed, the right of the board to act through a quorum is central to its ability to function in many situations.*

Plaintiffs suggest (Brief in Opposition, pp. 6-7, n. **) that the minority directors were "subject to great pressure and control by the malefactors who comprise the majority [of the board of directors]" and that (Brief in Opposition, p. 5, n. *) "[t]he tactic adopted to obtain dismissal was carefully planned and orchestrated." These suggestions were shown to be baseless in the proceedings below. See Petition, p. 5, n. *. The independence of the deciding directors was the subject of extensive discovery by plaintiffs following the District Court's first opinion, and was thereafter fully argued and briefed in the District Court. In its

* The propriety of acting through less than a strict numerical majority of the full board of directors is expressly confirmed in the Delaware General Corporation Law, which provides flexible mechanisms for corporate decision making. Section 141(b) of that statute provides for decision by majority vote of a quorum (which itself can consist of less than a numerical majority of the whole board), and Section 144(a) permits a corporate board to act, in certain cases, by majority vote of its disinterested directors even though they constitute less than a quorum. 8 Del. Code §§ 141(b), 144(a) (1974). The latter section is, of course, consistent with analogous principles of the Investment Company Act of 1940. See, *e.g.*, Sections 15(c) and 10 of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-15(c) and 80a-10 (1970), which provide that renewal of the adviser's contract requires a majority vote of the disinterested directors and that only 40% of the fund's directors need be disinterested. See also: Comment, *Duties of the Independent Director in Open End Mutual Funds*, 70 Mich.L.Rev. 696 (1972).

second opinion, the District Court expressly considered and rejected each of plaintiffs' arguments, finding (426 F.Supp. at 849):

> "Plaintiffs have not adduced any factual support for their conclusion that the members of the disinterested quorum acted other than independently."

The Court of Appeals' opinion does not disturb this finding.

3. Plaintiffs next argue (Brief in Opposition, pp. 9-10) that the board's action is tantamount to a ratification of fraudulent or illegal acts by the defendants. The courts have repeatedly rejected that argument, and recognized that

> "The question whether it is good judgment to sue is quite apart from the question of ratification."

S. Solomont & Sons Trust, Inc. v. *New England Theatres Operating Corp.,* 326 Mass. 99, 111, 93 N.E.2d 241, 247 (1950). Accord: *Kessler & Co.* v. *Ensley Co.,* 129 F. 397, 399 (C.C.N.D. Ala. 1904); *Gall* v. *Exxon Corp.,* 418 F.Supp. 508, 518 n.8 (S.D.N.Y. 1976). The District Court also correctly drew that distinction (404 F.Supp. at 1180). In addition, the wrongs involved in the cases cited by plaintiffs involved looting of the corporation or self-dealing by the defendants—no such wrongs are alleged in the instant case which simply involves an investment decision that resulted in a loss instead of a profit.*

* The plaintiffs' argument, moreover, overlooks the numerous other cases where the courts have upheld the power of disinterested directors not to pursue litigation, even though arguably nonratifiable conduct was at issue. See, *e.g., Alleghany Corp.* v. *Kirby,* 344 F.2d 571, 573 (2d Cir. 1965), *cert. dismissed,* 384 U.S. 28 (1966) (involving fraud claims); *Swanson* v. *Traer,* 249 F.2d 854, 856 (7th Cir. 1957) (involving fraudulent conspiracy); *Goodwin* v. *Castleton,* 19 Wash. 2d 748, 764, 144 P.2d 725, 733 (1944) (involving fraud claims); *Brody* v. *Chemical Bank,* 517 F.2d 932 (2d Cir. 1975) (involving federal securities acts and fraud claims); *Gall* v. *Exxon Corp.,* 418 F.Supp. 508 (S.D.N.Y. 1976) (involving illegal payments). Plaintiffs' reliance on *Mayer* v. *Adams,* 37 Del.Ch. 298, 141 A.2d 458 (1958), is misplaced. The only issue presented in *Mayer* was that of necessity for a demand on shareholders; the role of directors in deciding whether to pursue proposed derivative claims was not at issue. Rule 23.1 (and the comparable Delaware Chancery Court Rule 23.1) only requires such shareholder demand "if necessary." This requires examination, under state law, of shareholders' power to ratify alleged fraud. *See* 3B Moore's Federal Practice ¶ 23.1.19, at 23.1-94 (2d ed. 1978). In *Mayer,* the Court suggested that a unanimous shareholder vote could accomplish a ratification (37 Del. Ch. at 302, 141 A.2d at 460); thus, demand on the shareholders in *Mayer* would have been a futile gesture because the derivative plaintiffs would have voted against ratification. Moreover, the Court clearly recognized that a shareholders' meeting was "not an appropriate forum" for deciding the "probable merits of a minority stockholder's suit" because it would be difficult in all but the simplest cases to have "a reasonably complete presentation and consideration of evidentiary facts." 37 Del. Ch. at 303, 141 A.2d at 461. In the case at bar, of course, the merits of the proposed case were exhaustively considered in a series of directors' meetings, as is customary with respect to important corporate litigation, and by distinguished independent counsel, former Chief Judge Fuld.

Reply to Plaintiffs' Point II

1. Plaintiffs attempt (Brief in Opposition, p. 12) to avoid the conflict between the Court of Appeals' opinion at bar and *In re Kauffman Mutual Fund Actions,* 479 F.2d 257, 266-67 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973) by referring to other decisions in the Second Circuit which have cited *Kauffman.* Those decisions, however, cited portions of *Kauffman* not at issue here. The matter at issue here is the business judgment rule, not the necessity of pleading the futility of demand on the directors.

2. Plaintiffs next argue (Brief in Opposition, pp. 14-15) that:

> "The question which the Court of Appeals focused upon in the present case was whether the Investment Company Act conferred special power on minority independent mutual fund directors so

as to permit them to abort a derivative action in a situation where directors of other kinds of business corporations could not do so."

This erroneous formulation of the question stands the matter on its head. Congress provided for mutual funds to be organized under state law. Hence, consistent with this Court's holding in *Sante Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 479 (1977), the pertinent inquiry is not whether the Investment Company Act of 1940 expressly authorizes the board's action, but rather whether it expressly prohibits that which Delaware law permits regarding the internal management of the Fund. Neither plaintiffs nor the Court of Appeals could point to any express provision of the Investment Company Act of 1940 prohibiting the directors from exercising their business judgment as they did.

3. Plaintiffs next urge (Brief in Opposition, p. 16) that the opinion of the Court of Appeals does not "[impute] into the provisions of Section 36(a) [of the Investment Company Act of 1940] the broader provisions of Section 36(b). . . ." This is plainly wrong. The imposition of the separate standards of Section 36(b) upon those of Section 36(a) was central to the decision of the Court of Appeals. Thus the Court of Appeals wrote (567 F.2d at 1212):

> "It would surely be anomalous to hold that the statutorily disinterested directors could determine not to pursue litigation against their co-directors for liability which may amount to many millions of dollars, and foreclose the stockholders from continuing such litigation [under Section 36(a)], while at the same time stockholders by statute are empowered to recover excess fees paid the adviser and underwriter [under Section 36(b)]."

The Court of Appeals was in error in this reasoning. As shown in the Petition (pp. 17-21), such an implication of statutory intent is contrary to the pertinent legislative history and the rationale of Sections 36(a) and 36(b). The District Court correctly recognized the important distinction between those sections (Petition, p. 12a; see also 404 F.Supp at 1179-80).

4. Plaintiffs also incorrectly emphasize (Brief in Opposition, p. 18) the allegedly "nonfrivolous" nature of their action. The decisions of this Court dealing with the business judgment rule and its application to the question whether a corporation should pursue litigation specifically recognize and confirm the right of the board of directors to forego prosecution even of legally meritorious or valid claims. See, *e.g., Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903):

> "The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right."

As detailed in the District Court's first opinion (404 F.Supp. at 1176-77), the Fund directors considered and relied upon many such factors in determining that it would be contrary to the best interests of the Fund to pursue the claims plaintiffs would now have them assert. Moreover, contrary to plaintiffs' contentions regarding the alleged merit of their claims, Judge Fuld, independent special counsel, concluded (see 404 F.Supp. at 1176):

> "As a result of my analysis of the facts and the law, it is my opinion that there was no violation by

Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper."

The District Court, in its second opinion, which followed extensive discovery by plaintiffs, also rejected the claim that the independent directors were not truly "independent" based upon the manner in which they were selected and the fact that they received compensation for serving as directors (see 426 F.Supp. at 849 and 850).

5. Finally, plaintiffs argue (Brief in Opposition, p. 19) that the procedure followed by the disinterested directors at bar renders Rule 23.1 "meaningless." Rule 23.1 complements the business judgment rule by assuring that, absent certain unusual circumstances, every corporate board of directors will be permitted to decide whether or not to pursue litigation for the corporation's benefit. This, defendants submit, is why the so-called "demand" cases are supporting authority for their position at bar. Plaintiffs' position reduces to a claim that the delegation of board authority to and decision by a quorum consisting of Fundamental's independent directors was null and void. But the delegation of the authority to decide and the decision itself were accomplished within the framework of state law, and plaintiffs have cited no case condemning such an approach. The fact that it may be a new approach does not mean that it is in any way improper as a matter of law or sound policy.

The District Court recognized that Fundamental's actions were consistent both with the law of its home state and with the general state and federal policy favoring resolution of questions of corporate management within

the corporate structure. Moreover, the District Court gave plaintiffs every opportunity to explore the question of the independence of the deciding directors, thus obviating any suggestion of unfairness in the result. By its reversal, the Court of Appeals has seriously undermined the business judgment rule in the context of derivative actions involving mutual funds.

CONCLUSION

A writ of certiorari should issue to the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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